

DEPARTMENT OF STATE REVENUE**LETTER OF FINDINGS NUMBER: 96-0198****Income Tax****For Tax Periods 1990-1993**

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ISSUE**I. Income Tax—Long Term Contract Adjustment**

Authority: Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768 (1992); IC 6-3-2-2; 45 IAC 3.1-1-23; 45 IAC 3.1-1-29; 45 IAC 3.1-1-51; 45 IAC 3.1-1-52

Taxpayer protests the disallowance of adjustments to long-term contracts.

STATEMENT OF FACTS

Taxpayer manufactures industrial and aerospace products. Taxpayer absorbed a formerly wholly owned subsidiary in 1988. The subsidiary had long-term contracts and used the completed contract method of accounting to report income for Federal and state income tax purposes. As the result of an audit, the Indiana Department of State Revenue ("Department") disallowed taxpayer's deferred income adjustments for 1990, 1991 and 1992. Taxpayer protests the disallowance. Further facts will be provided as necessary.

I. Income Tax—Long Term Contract Adjustment**DISCUSSION**

Taxpayer claimed deferred income adjustments for three of five years of the audit period based on earned income (loss) from previous years. The Department disallowed the deductions for 1990 and 1992, and the increase to income for 1991. The Department based its decision on two regulations, 45 IAC 3.1-1-23(1) and 45 IAC 3.1-1-29. 45 IAC 3.1-1-23(1) states:

When a taxpayer moves to Indiana and becomes a resident and/or domiciliary of Indiana during the taxable year, Indiana will not tax income from sources outside Indiana which the taxpayer received prior to becoming an Indiana domiciliary.

Indiana will, however, assess adjusted gross income tax on all taxable income after the taxpayer becomes an Indiana resident.

45 IAC 3.1-1-29 states:

“Business Income” is defined in the Act as income from transactions and activity in the regular course of the taxpayer’s trade or business, including income from tangible and intangible property if the acquisition, management, or disposition of the property are integral parts of the taxpayer’s regular trade or business.

Nonbusiness income means all income other than business income.

The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, non-operating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is “business income” or “non-business income” is the identification of transactions and activity which are the elements of a particular trade or business.

The adjustments taken by taxpayer represent income or loss earned, but unreported for tax purposes, by a subsidiary prior to December 31, 1988. At that time the subsidiary and taxpayer merged. The subsidiary had no nexus with Indiana prior to its merger with taxpayer, however taxpayer (and its former subsidiary as a result of merger) had nexus with Indiana during the audit period. Taxpayer reported income on its 1990 and 1992 returns and a loss in 1991 using the completed contract method of accounting.

Taxpayer refers to Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 778 (1992), which states in part:

Although our modern due process jurisprudence rejects a rigid, formalistic definition of minimum connection, we have not abandoned the requirement that, in the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax, see Quill Corp. v. North Dakota, ante, at 306-308.

Taxpayer manufactured parts outside of Indiana and shipped them to its buyer outside of Indiana. Taxpayer protests that there is no connection between Indiana and the activity being taxed, and therefore the activity may not be taxed.

The Department refers to IC 6-3-2-2(b), which states in relevant part:

Except as provided in subsection (l), if business income of a corporation or a nonresident person is derived from sources within the state of Indiana and from

sources without the state of Indiana, then the business income derived from sources within this state shall be determined by multiplying the business income derived from sources both within and without the state of Indiana by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three (3).

45 IAC 3.1-1-51 states in relevant part:

The denominator of the sales factor includes all gross receipts from the taxpayer's sales, except as noted in Regulation 6-3-2-2(1)(010) [45 IAC 3.1-1-62].

45 IAC 3.1-1-52 states in relevant part:

The numerator of the sales factor generally includes gross receipts from sales attributable to this state, and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales regardless of where the accounting records are maintained or the location of the contract or other evidence of indebtedness

Therefore, IC 6-3-2-2(b) provides that Indiana will only tax income attributable to Indiana, via the standard apportionment formula. Indiana related income is listed in the numerator of the sales factor, while all income is listed in the denominator of the sales factor.

Taxpayer is correct in its assertion that Allied-Signal prohibits Indiana from taxing income earned from activities conducted wholly outside its borders. Standard apportionment procedures, as described in IC 6-3-2-2(b), provide that Indiana will not tax income earned from activities conducted wholly outside its borders. Taxpayer's adjustments distorted the standard apportionment formula, and the Department properly disallowed the adjustments.

FINDING

Taxpayer's protest is denied.

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